

1 **DAUFUSKIE ISLAND UTILITY COMPANY, INC.**

2
3 **DOCKET NO. 2011-229-WS**

4
5 **PRE-FILED TESTIMONY OF LYNN M. LANIER**

6
7 **BEFORE THE SOUTH CAROLINA PUBLIC SERVICE COMMISSION**

8
9 **Testimony Prepared: May 3, 2012**

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11 **Hearing Date: May 30, 2012**

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13 **THIS TESTIMONY IS FILED PURSUANT TO PSC LETTER DATED MARCH 20, 2012.**
14 **THE INTERVENOR RESERVES THE RIGHT TO PROVIDE ADDITIONAL**
15 **TESTIMONY CONCERNING FURTHER INTERROGATORY RESPONSES AND**
16 **REBUTTAL TESTIMONY TO BE PRE-FILED PURSUANT TO SAID ORDER, BY THE**
17 **APPLICANT AND/OR ANY OTHER PARTY TO THIS PROCEEDING.**

18 **MR. BEACH: PLEASE STATE YOUR NAME, EMPLOYER AND BUSINESS**
19 **ADDRESS.**

20 **MR. LANIER:** My name is Lynn M. Lanier and I am employed by GDS Associates, Inc.
21 ("GDS"), a utility consulting and engineering firm with its principal offices in Marietta, GA. I
22 am a Principal in the Firm. My business address is 1850 Parkway Place, Suite 800, Marietta, GA
23 30067.

24 **MR. BEACH: PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND:**

25 **MR. LANIER:** I hold a Bachelor of Science Degree in Industrial Management from the
26 Georgia Institute of Technology, with emphasis in economics and finance.

27 **MR. BEACH: PLEASE SUMMARIZE YOUR PROFESSIONAL EXPERIENCE.**

1 **MR. LANIER:** I have been employed in the utility business for my entire career of over 38
2 years. From 1972 to 1977, including part of the time while I was a student in college, I was
3 employed by Southern Engineering Company of Georgia as a utility rate analyst, where most of
4 my work was related to determining revenue requirements, cost allocation, and rate design,
5 primarily on behalf of utility companies, but also representing intervenors in rate cases at the
6 state and federal level. From 1977 to 1989, I was employed in various senior management
7 positions with electric cooperatives in Georgia and South Carolina, including a 6 year stint as
8 CEO of an electric cooperative in South Carolina. From 1989 until the present, I have been
9 employed as a Senior Consultant with GDS Associates, Inc., primarily in the areas of utility
10 rates, cost of service, rate design (both wholesale and retail), and numerous miscellaneous rate
11 and cost of service projects, including a recent water and sewer rate case before this
12 Commission. In addition, since about 1995 I have been the Firm's Practice Leader in the US
13 Dept of Defense Utility Privatization Program, where I have led the Firm's efforts in assisting
14 electric and water/wastewater utilities in their efforts to acquire electric, gas, water, and
15 wastewater systems on DOD installations. In this regard, we have represented several investor-
16 owned water/wastewater utility companies and/or affiliates. These projects require the
17 development of projected revenue requirements in order to establish pricing for the contract
18 offer. I have been a Principal in the Firm since 1995. My professional resume is included as
19 Exhibit 1.

20 **MR. BEACH: HAVE YOU PREVIOUSLY PRESENTED TESTIMONY BEFORE THIS**
21 **OR OTHER REGULATORY COMMISSIONS, COURTS, ETC.?**

1 **MR. LANIER:** Yes. I have presented expert testimony before the state regulatory commissions
2 in Indiana, Louisiana, Michigan, Mississippi, Texas, Vermont, and Virginia. In addition, I have
3 presented testimony before the United States Tax Court. In the recent Kiawah Island Utility, Inc.
4 rate case before this Commission, I provided testimony on several issues, including rate base,
5 rate of return on rate base, return on equity, operating margin, etc., in the representation of a
6 property owner's group that had intervened in the Case. I have also presented testimony as a
7 company witness before the South Carolina Public Service Commission as a fact witness in a
8 territorial matter and in a matter pertaining to the acquisition of a small private power company
9 while I was CEO of Lynches River Electric Cooperative, Inc. in Pageland, SC.

10 **MR. BEACH: WHAT HAS BEEN YOUR EXPERIENCE IN UTILITY RATE CASES**
11 **AND RELATED MATERS IN UNREGULATED JURISDICTIONS?**

12 **MR. LANIER:** I have already mentioned my experience in representing entities, primarily
13 utility companies or utility company affiliates, in pursuing utility privatization contracts on US
14 military bases. That work has included the development of proposals, including the development
15 of price proposals for electric, gas, water, and wastewater systems. The systems range from
16 small to relatively large and require the development of the projected costs or revenue
17 requirements, including profit or margin levels, for the Price Proposals. In addition, beginning
18 with my experience with Southern Engineering Company of Georgia in 1972 and continuing
19 throughout my career in utility management positions and over the course of my career at GDS
20 from 1988 until now, I have done a tremendous amount of rate work for electric cooperatives
21 and a few municipal electric systems, and a few publicly owned gas and water/wastewater
22 systems, throughout the US. Some of this was in a support role to other consultants within the

1 firm. Presently, I and/or my firm represents and performs utility rate services for almost all of
2 the 20 electric cooperatives in South Carolina. While they may not be subject to state regulatory
3 commission rate regulation, the development of revenue requirements is very similar, if not
4 virtually the same, as is done in the regulated arena, including the development of revenue
5 requirements on the basis of rate of return on rate base as well as other approaches such as and
6 including interest coverage, sometimes referred to as “Times Interest Earned Ratio” or TIER.

7 **MR. BEACH: WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS MATTER?**

8 **MR. LANIER:** The purpose of my testimony is incorporate the expense and rate base
9 adjustments proposed by my colleague Ms. Ellen Blumenthal into our view of the Daufuskie
10 Island Utility Company, Inc.’s (DIUC’s or “the Company’s) revenue requirements and to
11 present an alternate approach for determining the Return on Equity or profit level in the
12 determination of total revenue requirements; and finally, to recommend a schedule of rates and
13 charges reflecting the recommended revenue requirements and profit level.

14 **MR. BEACH: HAVE YOU REVIEWED THE RATE FILING APPLICATION OF DIU**
15 **IN THIS CASE AND PARTICULARLY THE PROPOSED REVENUE**
16 **REQUIREMENTS, THE EQUITY RETURN REQUESTED, AND THE OVERALL**
17 **REVENUE INCREASE REQUESTED?**

18 **MR. LANIER:** Yes I have.

19 **MR. BEACH: AND WHAT IS YOUR OVERALL ASSESSMENT OF THE COMPANY’S**
20 **FILING?**

1 **MR. LANIER:** While the Company is obviously experiencing challenging times, I believe that
2 the Company's requested increase is excessive and that the attempt to implement uniform rates,
3 particularly in view of the almost 100% requested increase in revenues, is inappropriate at this
4 time. The increase would result in complete rate shock for the Company's customers and the
5 property owners to whom availability fees are charged. In my view, the Company is not being
6 operated in the most efficient and economical fashion and, in fact, is being operated poorly. That
7 being the case, I think it would be a serious mistake for the Commission to grant even a
8 significant portion of the Company's requested increase, as that would not encourage the
9 Company to improve its operations and management practices. **Almost all of the Company's**
10 **request is for the purpose of increasing the profit level or return on equity**, when in fact,
11 what the Company needs is an injection of debt capital to fund some badly needed capital
12 improvements and repairs. And I believe that the Company can obtain the debt capital that it
13 really needs without the profit margin/return on equity that the Company is requesting.

14 **MR. BEACH: HAVE YOU REVIEWED THE COMPANY'S RATE FILING**
15 **APPLICATION AND PARTICULARLY THE PROPOSED REVENUE**
16 **REQUIREMENTS, THE EQUITY RETURN REQUESTED, AND THE OVERALL**
17 **REVENUE INCREASE REQUESTED?**

18 **MR. LANIER:** Yes, I have. According to the Application, for the combined water and sewer
19 systems, DIUC is requesting adjusted operating expenses of \$755,783 and proposed revenues of
20 \$1,486,291, resulting in an overall 97.6% increase in rates and charges. This request results in
21 an increase in the Company's Net Operating Income (i.e., income for return) from the test year
22 level of \$75,246 to \$542,917, which equates to an 8.34% Rate of Return on the Company's

1 claimed, but, I believe significantly inflated, rate base, and an operating margin of 36.5%. (See
2 Exhibit-2). Interestingly, the Company does not provide the Operating Margin calculation on any
3 of its income statement schedules in the application (i.e., A-4, WC, and SC), although the
4 Company and its experts are obviously aware of the requirements of SC Statute 58-5-240(H),
5 which requires that in Water and Sewer Rate Cases, the Commission “specify” an operating
6 margin. In fairness to the Company, though, as shown on Schedule A-3 of the application, the
7 Company is proposing a pro forma capital structure, in which a \$3.5 million debt issue would
8 replace the same amount of equity capital, at a proposed interest rate of 6.5%. This would result
9 in interest expense of \$227,175 annually. Since interest expense has been included in the
10 revenue requirements calculations on Schedules W-F.1 and S-F.1, and the tax calculations on W-
11 C.1 and S-C.1 include the deduction for interest expense, it is only necessary to deduct interest
12 expense from Net Operating Income to determine Operating Margin. As shown, the Operating
13 Margin would be a very healthy and, in my opinion, excessive 21.2%, which also represents an
14 after tax return of 10.5% on the equity portion of the Company’s claimed rate base.

15 **MR BEACH: DO YOU AGREE WITH THE SCHEDULES PREPARED BY**
16 **GUASTELLA ASSOCIATES IN SUPPORT OF THE COMPANY’S APPLICATION?**

17 **MR. LANIER:** No. I do not. My colleague, Ms. Blumenthal and I have thoroughly reviewed
18 all of the schedules included with the application prepared by Guastella Associates, as well as all
19 the responses that the Company has made to questions and requests for information by the Office
20 of Regulatory Staff (“ORS”) and by our clients, and we have made a number of adjustments. In
21 her testimony, Ms. Blumenthal recommends a number of expense and rate base adjustments, the
22 rationale for which she provides in her testimony. In addition, I have made one revenue

1 adjustment, in addition to those made by the Company, but which provides a relatively
2 significant annual increase in revenue, such that the Company's Adjusted Net Operating Income
3 under present rates and charges would be positive, resulting in a smaller needed revenue
4 increase.

5 I should point out that the Company was gracious enough to provide the functional MicroSoft
6 Excel Workbook used in the application and prepared by Guastella Associates, entitled
7 "Schedules in Support of a Rate Increase" and dated December 2011. Since the Company and
8 ORS are familiar with this set of schedules, we have made our adjustments, using the same set of
9 schedules, although we have altered calculations used to reflect the adjustments we have
10 proposed. Our version of the Schedules, which I am sponsoring in whole and which Ms.
11 Blumenthal is sponsoring, in part, is attached hereto as Exhibit - 3.

12 **MR. BEACH: WHAT WAS THE ONE REVENUE ADJUSTMENT YOU MADE TO**
13 **THE COMPANY'S ADJUSTED REVENUES?**

14 **MR. LANIER:** The Company charges Service Availability Fees to lot owners in the various
15 developments on the island, where water and/or sewer service have been made available, but
16 where there is not yet any structure on the lot. There are two developments on the Island, Oak
17 Ridge and Beech Field, where there are approximately 100 lots in which water and sewer service
18 has been made available, but the Company is not currently charging the lot owners the Service
19 Availability Fees. The developments are in close proximity to the Melrose Plantation and
20 Bloody Point developments. Homes in these two developments are currently charged the
21 Melrose Plantation/Bloody Point rates and undeveloped lots are charged the Melrose
22 Plantation/Bloody Point availability fees, such that it would be appropriate to consider these lots
23 under the Melrose Plantation/Bloody Point Availability Fees. The Availability Fee for water and

1 sewer is \$58.50 each per quarter, representing a total of \$117 per lot, per quarter. Thus, 100 lots
2 times \$117 per quarter, times 4 quarters, equals \$46,800 per year in additional revenues under
3 current rates and charges. The Company claims that the schedules of Availability Fees has been
4 approved by the Commission and, therefore, the Company should be obligated to charge
5 Availability Fees to all lot owners subject to such fees. Applying these fees to Oak Ridge and
6 Beach Field increases water system revenues and sewer system annual revenues by \$23,400
7 each. I have made these adjustments to Pro Forma Present Rates on Schedules W-C and S-C in
8 Exhibit- 3. These are also reflected in the totals on Schedule A-4.

9 **MR. BEACH: WHAT ADJUSTMENTS HAVE BEEN MADE TO THE COMPANY'S**
10 **OPERATING EXPENSES AND DEDUCTIONS?**

11 **MR. LANIER:** As outlined in her testimony, Ms. Blumenthal recommends adjustments to the
12 Company's Pro Forma Adjusted expenses, as shown on Schedules W-C and S-C in Exhibit-3.
13 As shown on Schedule W-C, Ms. Blumenthal recommends adjustments which reduce DIUC's
14 water system expenses by \$35,109. On Schedule S-C, Ms. Blumenthal recommends adjustments
15 which reduce DIUC's wastewater system expenses by \$21,816.

16 **MR. BEACH: DO YOU AGREE WITH THE COMPANY'S CLAIMED RATE BASE**
17 **AND RETURN ON RATE BASE?**

18 **MR. LANIER:** No, I do not. As Ms. Blumenthal demonstrates in her testimony, the
19 Company's rate base is overstated. Table 1 in her testimony summarizes her adjustments to both
20 the water and wastewater rate bases which she supports. These adjustments are included in
21 Schedules W-B and S-B, and are used as the total capital amount in the Capital Structure on

1 Schedule A-3. The water system rate base, as adjusted, is \$2,191,193. The wastewater system
2 rate base, as adjusted, is \$2,820,123.

3 **MR. BEACH: DO YOU AGREE WITH THE COMPANY'S APPROACH OF USING**
4 **RETURN ON RATE BASE AS THE APPROPRIATE MANNER OF DETERMINING**
5 **WHAT THE COMPANY NEEDS IN TERMS OF AN EQUITY RETURN?**

6 **MR. LANIER:** No, I do not. Using Ms. Blumenthal's adjusted rate base amounts, together
7 with the recommended adjustments in expenses and deductions for the water and sewer systems,
8 along with my adjustment to revenues for the additional availability fees, results in the need for a
9 smaller rate increase. However, providing the Company with an overall return on rate base of
10 8.34% still results in an increase that I believe to be excessive and unwarranted and provides the
11 Company with a return on equity that, under the circumstances, I believe is unjustified.

12 **MR. BEACH: ARE YOU PROPOSING AN ALTERNATE APPROACH FOR**
13 **DETERMINING AN APPROPRIATE RETURN ON EQUITY OR PROFIT?**

14 **MR. LANIER:** Yes, I am. On Schedule A-3.1 of the Schedules included in Exhibit-3, I have
15 listed all the capital needs claimed by the Company. In his testimony, Mr. Guastella states that
16 while he believes he can obtain financing for the \$3.5 million in debt issuance from CoBank, he
17 also states that the lenders he has spoken with, presumably including CoBank, will not advance
18 funds to DIUC until an approximately \$1.3 million loan from Coastal States Bank to CK
19 Materials, the parent of DIUC, is paid off, so that the DIUC assets will be free of any liens.
20 Apparently, the assets of DIUC are pledged by CK Materials as collateral for the \$1.3 million
21 loan. In addition, Mr. Guastella has attached to his testimony a schedule of capital improvement

1 and repair items that the Company claims need to be made. In his testimony, Mr. Guastella also
2 mentions a repair that needs to be made to a waste treatment lagoon, at the cost of \$100,000 to
3 \$200,000. I used the \$200,000 amount and all of the amounts exactly as listed by Mr. Guastella
4 in his attached schedule, which total \$2.5 million. While Mr. Guastella proposes a debt infusion
5 of \$3.5 million, it appears that the Company's actual capital needs are only \$2.5 million. Mr.
6 Guastella does state that the \$3.5 million is needed for capital improvement, repairs, and other
7 needs, but it appears that other needs would be approximately \$1.0 million in operating capital,
8 which he has not shown that the Company needs.

9 Mr. Guastella also stated in his testimony that he expected the loan to come from CoBank, at a
10 rate of 6.5%. CoBank is a major lender to electric cooperatives and I have dealt with CoBank a
11 good bit in the past. CoBank is a cooperative and distributes a portion of its profits or patronage
12 capital to its borrowers each year. The normal cash distribution is equal to 65 basis points and
13 another 10 basis points is distributed as assigned margins. I have subtracted the 75 basis point
14 CoBank distribution from the 6.5% rate quoted by Mr. Guastella. I have reflected the net rate of
15 5.75% in Schedules A-3, W-D, and S-D in Exhibit-3.

16 Rather than a return in equity, as requested by the Company, I believe a more appropriate
17 approach would be for the Commission to provide an interest coverage allowance. An interest
18 coverage of 1.5 times is commonly used in the utility industry. This coverage level reimburses
19 the utility for the interest it pays and provides an equity return of 0.5 times the interest expense.
20 I recognize that the Company needs cash, but the Commission should not authorize more than
21 \$2.5 million of new debt. The interest on this \$2.5 million at 5.75% is \$143,750. The 50 basis
22 point margin included in the 1.5 times interest coverage translates to \$71,875, which is the after

1 tax equity return. This amount then needs to be grossed up for state gross receipts tax and state
2 and federal income tax.

3 I have assigned the \$2.5 million debt to the Water and Sewer systems based on each system's
4 Rate Base as shown on Schedules W-D and S-D. On this basis, the 50 basis point margin of
5 \$71,875 would result in \$31,334 being assigned to the Water System (See Schedule W-F.1) and
6 \$40,328 being assigned to the Sewer System (See Schedule S-F.1). On my Schedule W-F.1, the
7 \$31,334 assigned to the Water System is grossed up for gross receipts tax and state and federal
8 income tax, to arrive at a before tax equity return of \$42,152. The Total Revenue Requirement
9 for the Water System is \$470,202. A federal tax rate of 21% was used in the gross up
10 calculation. This rate is the federal tax rate that would be applied to the Company's total net
11 income using the interest coverage approach. The equity return for the sewer system is \$42,152,
12 as shown on my Schedule S-F.1. When this amount is grossed up for gross receipts tax and state
13 and federal income tax, the total before tax return is \$54,250, resulting in a total revenue
14 requirement for the sewer system of \$443,987.

15 The rate of return on rate base (as adjusted) for the utility is 4.3% (See Schedules A-3, W-D, and
16 S-D). This rate of return is calculated using a 5.75% cost of debt and a 2.86% cost of equity.

17 **MR. BEACH: WHY DO YOU FEEL THAT THIS RETURN ON EQUITY IS**
18 **JUSTIFIED?**

19 **MR. LANIER:** In my opinion, DIUC is not being managed effectively or economically. As has
20 been revealed in the Company's filing, Mr. Guastella's firms, Guastella Associates, LLC and G₂
21 have been hired to manage DIUC. Mr. Guastella is an honorable man and I do not fault him for
22 taking the assignment, but the fact that a small water and sewer utility company with less than

1 500 active customers has to resort to hiring a Boston based consulting firm to manage its affairs
2 is an indictment of the inability or incapability of the parent/stockholder to manage the utility
3 company. There are also other indicators that the Company is not being managed well. For
4 example, it has come to light that the Company had not paid the taxes on a parcel of property on
5 which a water storage facility was located, and that this parcel was sold at auction by Beaufort
6 Count for the satisfaction of taxes owed. This is obviously an embarrassing situation and Mr.
7 Guastella felt compelled to address it in his testimony. Mr. Guastella's reason for why the
8 auction took place is that the Company did not receive a notice by mail from the County and,
9 therefore, did not know that the auction was going to take place. It is the taxpayer's
10 responsibility to pay these taxes whether or not they receive a tax bill. Consequently, the fact
11 that the utility and G₂ may not have received a tax bill does not justify its failure to timely pay
12 the property taxes due. This is clear evidence of the problems of a distant manager's ability to
13 exercise oversight over the affairs and activities of the Company. While Mr. Guastella says that
14 he has talked with the purchaser of the property, who seems reasonable, one would think that
15 anyone holding ownership of a piece of property that the Company obviously needs to reacquire
16 would use that leverage to extract a substantial price. And it would be completely unrealistic to
17 think otherwise.

18 Other indications that the Company is not well managed include the lack of or the lack of
19 adequate liability insurance, failure to pay taxes on properties owned, frequent payment of late
20 fees on bills for materials and supplies and services, and loan repayments. So while the
21 Commission should authorize a return on equity sufficient to allow the Company to earn a
22 margin or profit to provide reasonable security to the lender, the Commission should not
23 authorize anything more at this time. This will give the Company the incentive to pursue more

1 effective and more economical management of DIUC. Many capable people are available in the
2 area from Savannah, GA to Charleston and points in between, including Hilton Head, and
3 Daufuskie Island. Surely, DIUC can find someone in the reasonably local area, who can manage
4 DIUC. While the Company may well need the services of a firm such as Guastella Associates
5 from time to time, it should not need to turn over the complete management of the Company to
6 such a firm.

7 **MR. BEACH: IS PRECEDENT FOR AUTHORIZING SUCH A LOW RETURN**
8 **AUTHORIZED BY THE COMMISSION?**

9 **MR. LANIER:** Yes. In a recent Carolina Water rate case, ORS witness Dr. Douglas Carlisle
10 recommended a ROE range of 9.02% to 10.03%. In its order, the Commission denied the
11 utility's requested rate relief, but determined that the 6.42% ROE, as calculated by an ORS staff
12 witness, "was sufficient under the circumstances," but also acknowledged that the Company
13 would continue to have the opportunity to earn the authorized ROE of 9.4% granted in Order No.
14 2008-855. "Under the circumstances", as referred to in the Commission Order, referred to
15 significant weaknesses found in the Company's operations, not unlike the situation with DUIC.
16 On the night of April 30th, the Commission conducted a hearing on Daufuskie Island. The
17 hearing was well attended with numerous complaints voiced as to lack of presence of Company
18 management personnel, lack of responsiveness of management personnel, and the shock of the
19 proposed increase in rates and charges of almost 100% and more than that for some charges.
20 Thus, in my opinion, the Commission has more than sufficient justification to award an equity
21 return on the low end of the scale.

1 **MR. BEACH: IS THERE ANOTHER APPROACH THAT MIGHT BE APPROPRIATE**
2 **FOR THE COMMISSION TO TAKE IN DECIDING UPON DIUC'S RATE**
3 **APPLICATION?**

4 **MR. LANIER:** Yes, the Commission could set a fair rate of return for DIUC based upon an
5 operating margin approach.

6 **MR. BEACH: ARE THERE ANY REASONS WHY THE COMMISSION SHOULD**
7 **VIEW DIUC'S APPLICATION FROM THIS PERSPECTIVE?**

8 **MR. LANIER:** Yes. Based upon the makeup of this particular utility, operating margin could
9 be a more appropriate approach in this application.

10 **MR. BEACH: HAS THE COMMISSION ISSUED ANY ORDERS RECENTLY THAT**
11 **SUPPORT THE UTILIZATION OF AN OPERATING MARGIN METHODOLOGY IN**
12 **THIS CASE?**

13 **MR. LANIER:** It is my understanding that the Commission has chosen to set water and sewer
14 rates based upon Operating Margin for the overwhelming majority of Water/Sewer Rate utilities
15 under their jurisdiction. Indeed, in the recent Kiawah Island Utility case, Docket No. 2011-317-
16 WS, the Commission rejected the return on rate base approach and, instead, set the utility's rates
17 based upon operating margin.

18 **MR. BEACH: HAVE YOU TAKEN A POSITION BEFORE THIS COMMISSION**
19 **REGARDING WHETHER RATES SHOULD BE SET BASED UPON RETURN ON**
20 **RATE BASE OR OPERATING MARGIN?**

1 **MR. LANIER:** Yes, in the Kiawah case I recommended that the Commission set rates based
2 upon return on rate base instead of operating margin.

3 **MR. BEACH: DID THE COMMISSION ACCEPT YOUR RECOMMENDATION IN**
4 **THAT CASE?**

5 **MR. LANIER:** No, in the Commission's order issued on February 8, 2012 in the Kiawah case,
6 the Commission rejected the return on rate base methodology and expressly found that the
7 operating margin methodology was the more appropriate methodology.

8 **MR. BEACH: DID THE COMMISSION IN DOCKET 2011-317-WS SET FORTH ANY**
9 **REASON FOR ADOPTING OPERATING MARGIN THAT MIGHT ALSO CALL FOR**
10 **THAT SAME APPLICATION HERE?**

11 **MR. LANIER:** Yes. In rejecting return on rate base and adopting operating margin, the
12 Commission stated that it "has adjusted rates based upon the operating margin in all previous
13 rate applications of KIU." That is also the case here. In the previous applications of both Haig
14 Point Utility Company and Melrose Utility Company, the Commission set rates based upon
15 operating margin.

16 **MR. BEACH: HAVE YOU CALCULATED THE OPERATING MARGIN, BASED ON**
17 **THE COMPANY'S FILING AND BASED ON YOUR RECOMMENDED APPROACH**
18 **USING INTEREST COVERAGE FOR THE EQUITY RETURN?**

19 **MR. LANIER:** Yes. As shown on my Schedule A-4 of my Exhibit-2, I have calculated the
20 operating margin without any consideration for interest expense, as reflected in the Company's
21 Pro Forma Capital Structure. As shown, the Operating Margin would be 36.5%. Under the

1 assumption that the Company will borrow and pay interest at 6.5% on \$3.5 million, the interest
2 deduction would be \$227,175 and the Operating Margin would be \$315,742, or about 21.2% of
3 total revenues. Based on our revenue requirement in which the return is calculated using the
4 interest coverage methodology, the operating margin is 7.8%, as shown on my Schedule A-4 in
5 Exhibit-3. This calculation includes interest expense on \$2,500,000, at my recommended rate of
6 5.75%, and the state and federal income taxes on net income. It must be noted, though, that the
7 7.8% operating margin results largely from the infusion of \$2,500,000 in debt capital and the
8 interest thereon. However, the pro forma interest expense will not be incurred in whole
9 immediately, but will occur gradually as draws are made against the loan arranged by the
10 Company.

11 **MR. BEACH: HOW ADEQUATE DO YOU THINK THE OPERATING MARGIN**
12 **WOULD BE UNDER THE COMPANY'S FILING AND BASED ON YOUR**
13 **RECOMMENDATIONS OF THE EQUITY RETURN?**

14 **MR. LANIER:** In my opinion, the operating margin inherent in the Company's proposed
15 revenue requirement, either before (36.5%) or after considering a pro forma interest expense
16 (21.2%) is excessive. For example, in the last Haig Point Utility Rate Case (Docket No. 2005-
17 74-W/S), the Commission awarded a 12.34% Operating Margin. In the last Melrose Utility
18 Company case (Docket No. 2005-74-W/S), the Commission awarded a 9.34% Operating Margin.
19 Furthermore, in the recent Kiawah Island Utility rate case, the Commission awarded a 13.75%
20 Operating Margin. Under my recommended interest coverage approach, the operating margin
21 net of interest expense is 7.8%, which is both reasonable and adequate.

1 **MR. BEACH: HAVE YOU DEVELOPED ALTERNATIVE RATE DESIGNS TO**
2 **RECOVER THE REVENUE REQUIREMENT REFLECTED IN EXHIBIT-3 THAT**
3 **YOU AND MS. BLUMENTHAL HAVE DETERMINED?**

4 **MR. LANIER:** Yes. Using the template provided in the Excel Work Book provided by the
5 Company, I have recalculated the proposed rates.

6 The Company's approach, as reflected on Schedule W-F.2 (S-F.2 for Sewer) is to calculate
7 uniform rates for the DIUC (formerly Haig Point Utility Company) and Melrose
8 Plantation/Bloody Point (formerly Melrose Utility Company) customers and to eliminate the
9 22,500 gallon per quarter customer usage allowance enjoyed by the Melrose Plantation/Bloody
10 Point customers. The Company also proposes to make Availability Fees uniform.

11 Because the rate structures and availability fees for DIUC and Melrose Plantation/Bloody Point
12 are so different, and the revenue increase we are recommending is lower, I have calculated rates
13 based on the rate structures currently in effect. Melrose Plantation/Bloody Point customers
14 would continue to have the usage allowance and the Availability Fees would be different from
15 the DIUC area. My recommended rates (See Exhibit- 3) are shown on my Schedule W-F.2 (S-
16 F.2 for Sewer) and W-E.2 (S-E.2 for Sewer) and represent an increase in revenues over Pro
17 Forma Existing Rates (which include the additional Service Availability Revenue from Oak
18 Ridge and Beech Field), of 12.6% for the Water System, 16.5% for the Sewer System, and
19 14.5% (See Schedule A-4), overall. A comparison of my proposed rates and the Company's
20 proposed rates, along with comparisons to the Existing Rates is shown in Table 1, below:

TABLE 1

WATER	Existing	Company Proposed		Alternative Proposed	
		Rate	Increase	Rate	Increase
BASIC SERVICE:					
Residential-DIUC	\$45.00	\$106.05	135.7%	\$50.65	12.6%
Residential-MUC/BP	\$58.50	\$106.05	81.3%	\$65.85	12.6%
Commercial-DIUC	\$63.00	\$148.48	135.7%	\$70.91	12.6%
Commercial-MUC/BP	\$99.00	\$148.48	50.0%	\$111.43	12.6%
Multi-Family-MUC/BP	\$99.00	\$148.48	50.0%	\$111.43	12.6%
Availability Billing-DIUC	\$22.50	\$76.36	239.4%	\$25.33	12.6%
Availability Billing-MUC/BP	\$58.50	\$76.36	30.5%	\$65.85	12.6%
USAGE:					
Residential-DIUC	\$2.00	\$3.14	57.0%	\$2.25	12.6%
Residential-MUC/BP	\$1.77	\$3.14	77.4%	\$1.99	12.6%
Commercial-DIUC	\$2.00	\$3.14	57.0%	\$2.25	12.6%
Commercial-MUC/BP	\$1.41	\$3.14	122.7%	\$1.59	12.6%
Multi-Family-MUC/BP	\$1.41	\$3.14	122.7%	\$1.59	12.6%
TPL Treatment Plant-DIUC					
0 to 18,000 gals (quarterly)	\$2.00	\$3.46	73.0%	\$2.25	12.6%
18,001 to 60,000 gals	\$2.24	\$4.08	82.1%	\$2.52	12.6%
Over 60,000 gals	\$2.54	\$4.71	85.4%	\$2.86	12.6%
Irrigation-DIUC					
0 to 18,000 gals (quarterly)	\$2.00	\$3.46	73.0%	\$2.25	12.6%
18,001 to 60,000 gals	\$2.24	\$4.08	82.1%	\$2.52	12.6%
Over 60,000 gals	\$2.54	\$4.71	85.4%	\$2.86	12.6%
Irrigation-MUC					
0 to 18,000 gals (quarterly)	\$1.20	\$3.46	188.3%	\$1.35	12.6%
18,001 to 60,000 gals	\$1.20	\$4.08	240.0%	\$1.35	12.6%
Over 60,000 gals	\$1.20	\$4.71	292.5%	\$1.35	12.6%
SEWER	Existing	Company Proposed		Alternative Proposed	
		Rate	Increase	Rate	Increase
BASIC SERVICE:					
Residential-DIUC	\$80.00	\$148.01	85.0%	\$93.20	16.5%
Residential-MUC/BP	\$58.50	\$148.01	153.0%	\$68.15	16.5%
Commercial-DIUC	\$129.16	\$207.22	60.4%	\$150.47	16.5%
Commercial-MUC/BP	\$99.00	\$207.22	109.3%	\$115.33	16.5%
Multi-Family-MUC/BP	\$99.00	\$207.22	109.3%	\$115.33	16.5%
Availability Billing-DIUC	\$40.00	\$95.47	138.7%	\$46.60	16.5%
Availability Billing-MUC/BP	\$58.50	\$95.47	63.2%	\$68.15	16.5%
USAGE:					
Residential-DIUC	\$0.96	\$1.84	91.7%	\$1.12	16.5%
Residential-MUC/BP	\$1.41	\$1.84	30.5%	\$1.64	16.5%
Commercial-DIUC	\$0.96	\$1.84	91.7%	\$1.12	16.5%
Commercial-MUC/BP	\$1.41	\$1.84	30.5%	\$1.64	16.5%
Multi-Family-MUC/BP	\$1.41	\$1.84	30.5%	\$1.64	16.5%

1 **MR. BEACH: WHY DO YOU FEEL THAT A CONTINUATION OF THE PRESENT**
2 **RATE STRUCTURES AND THE PRESERVATION OF THE USAGE ALLOWANCE**
3 **FOR THE MELROSE PLANTATION/BLOODY POINT CUSTOMERS IS**
4 **APPROPRIATE?**

5 **MR. LANIER:** In my opinion, the impact of moving from the present rate structures as
6 proposed by the Company is simply too great a change to be acceptable.

7 **MR. BEACH: HOW DOES YOUR APPROACH TO THE DETERMINATION OF THE**
8 **REASONABLE AND NECESSARY RETURN DIFFER FROM THE APPROACH AND**
9 **RATIONALE OFFERED BY MR. GUASTELLA IN HIS TESTIMONY AND**
10 **EXHIBITS?**

11 **MR. LANIER:** None of the Company's witnesses addresses rate of return in prefiled testimony.
12 While the Company's Filing and the "Schedules in Support of a Rate Increase" included with the
13 Company's filing clearly show that the Company is requesting to use the Return on Rate Base
14 approach for revenue requirements and that the Company is requesting a 6.5% cost of debt and a
15 10.5% Return on Equity, the Company has provided no support whatsoever. The 10.5% Return
16 on Equity is not mentioned in Mr. Guastella's testimony and in Mr. White's testimony, he only
17 says that "the rate increase would generate a rate of return on equity of 10.5% ..." In fact, on
18 Schedule A-3 of the electronic version of the Company's application, the 10.5% Cost Rate for
19 Equity is an "input", such that the Return on Equity was clearly specified at 10.5%, rather than it
20 being a residual number. Furthermore, neither Mr. Guastella nor Mr. White offer support for
21 the 6.5% interest rate on the proposed debt issue. The only statement made is that they have
22 "estimated the rate to be 6.5%". No evidence of this interest rate by any financial institution has

1 been provided, to date. In my view, it is extremely presumptuous of the Company's expert
2 witnesses to expect the Commission to simply accept the 6.5% interest rate, the need for \$3.5
3 million in new debt, and a 10.5% return on equity, without any justification whatsoever, other
4 than a few vague assertions.

5 **MR. BEACH: IF THE COMMISSION SHOULD REJECT YOUR**
6 **RECOMMENDATION OF DETERMINING AN EQUITY RETURN BASED ON**
7 **INTEREST COVERAGE AND ALSO REJECT THE USE OF OPERATING MARGIN,**
8 **WHAT WOULD BE YOUR RECOMMENDATION?**

9 **MR. LANIER:** I would recommend that the parcel of land with the water tower and the water
10 tower, along with the Haig Point Wastewater Treatment Plant, be removed from the rate base,
11 and possibly some revenue requirements, such as property taxes on these assets, be eliminated.
12 A rate of return would then be calculated based upon only \$2.5 million in debt capital (based
13 upon the information that DIUC has currently provided as to its capital needs) and not more than
14 a 5.75% interest rate. And I would recommend a Return on Equity on the low end of a
15 reasonable range.

16 **MR. BEACH: WHAT WOULD YOU CONSIDER TO BE A REASONABLE RANGE IN**
17 **THIS CASE?**

18 **MR. LANIER:** In the Carolina Water Case, mentioned previously, the Commission determined
19 that a 6.42% Return on Equity was sufficient under the circumstances. Given the Company's
20 failure to properly manage its affairs, it is my opinion that a return on equity of not more than
21 6.42% would be at the extreme high end for this rate proceeding.

1 **MR. BEACH: DOES THIS CONCLUDE YOUR TESTIMONY?**

2 **MR. LANIER:** Yes, it does.

3 **END OF DIRECT TESTIMONY**

4

LIST OF EXHIBITS TO ACCOMPANY TESTIMONY

1

2

3 **EXHIBIT 1 – Professional resume of Lynn M. Lanier**

4 **EXHIBIT 2 – Schedule A-4 from DIUC’s Filing, with Operating Margin Calculations**

5 **calculations**

6 **EXHIBIT 3 – Alternative “Schedules in Support of a Rate Increase”**

BEFORE
THE PUBLIC SERVICE COMMISSION OF
SOUTH CAROLINA
DOCKET NO. 2011-229-W/S

RE:)	
)	
Application of Daufuskie Island Utility)	
Company, Inc. for Approval for Water)	CERTIFICATE OF SERVICE
and Sewer Rates, Terms and)	
Conditions)	

This is to certify that I have caused to be served this day the **Direct Testimony of Lynn Lanier** filed on behalf Haig Point Club and Community Association, Inc. ("HPCCA"), Melrose Property Owner's Association, Inc. ("MPOA"), and Bloody Point Property Owner's Association ("BPPOA") via electronic mail service as follows:

Shannon Bowyer Hudson, Esquire
Nannette S. Edwards, Esquire
Courtney Dare Edwards, Esquire
Office of Regulatory Staff
1401 Main Street, Suite 900
Columbia SC 29201
shudson@regstaff.sc.gov
nsedwar@regstaff.sc.gov
cedwards@regstaff.sc.gov

G. Trenholm Walker, Esquire
Pratt-Thomas Walker, PA
PO Drawer 22247
Charleston SC 29413
gtw@p-tw.com

Patrick M. Connelly, Esquire
General Counsel
McCarthy Floral Group
9390 Old Southwick Pass
Alpharetta, GA 30022
pmc@ggclegal.com

s/ Carol Roof _____
Carol Roof

May 3, 2012
Columbia, South Carolina